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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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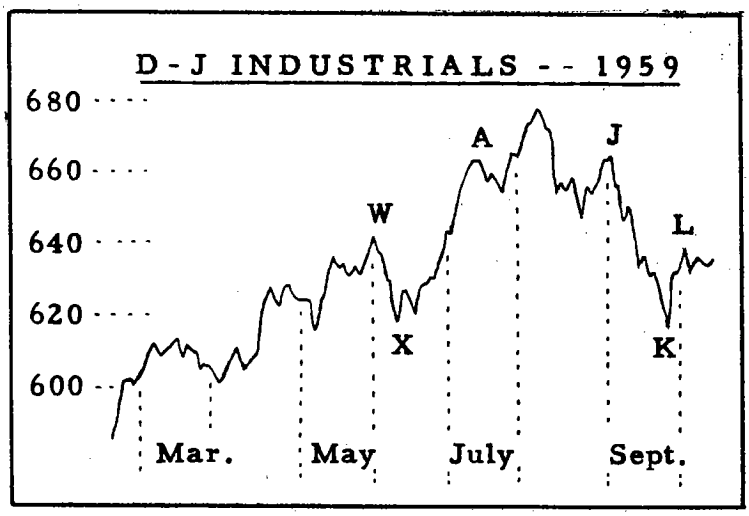
DISCOUNTING WHAT? Between May 30 and June 9, 1959, the Dow Jones industrials declined from 643.79 to 617.62 (W-X, see small chart). This decline occurred prior to the steel strike, and we may assume that among other things, the market was then discounting the worst that it could foresee in the coming period of steel negotiations (see Letter 72). Investors' fears have since been aroused by the length and bitterness of the steel strike, and news of steel shortages and lay-offs are now assuming headline proportions in the nation's press.

On the more recent decline (J-K) from the August peak, industrials again returned to the 616-617 level. This sell-off represented another return to the June 9 "safety level" wherein the worst of a possible steel strike had already been discounted. It is interesting to note that on the August-September retreat industrials held at about the June 9 low, and volume refused to expand as the earlier 617.62 was penetrated by a little over one point.



From the September lows (K), a sharp rally (K-L) commenced, and this movement served as a full correction of the entire reaction since the highs. At the top of the K-L rally the averages formed a "line" as volume grew typically dull. The market was appraising the economic picture, but (as explained in Letter 81) it was now apparent that much more was involved than the single issue of a steel strike. "The Market", runs the old adage, "never discounts the same situation twice."

As I see it, the Dow Theory now points to either of two broad alternatives: if the two averages advance in the familiar ascending zig-zag pattern, and if the July-August highs (industrials 678.10, rails 173.56) are eventually bettered, the market will be saying that present problems have been resolved and that a continuation of the boom is in order. On the other hand, if the reaction lows at K (industrials 616.45, rails 150.28) are violated with accompanying heavy volume, the market will be indicating that new and (as yet) undiscounted dangers lie ahead. Such a penetration would hold primary significance, and should be taken by Dow Theorists as proof that the primary trend has turned from bull to bear.

"Except by the averages," wrote Rhea, "no bear market in stocks or a business depression has ever been advertised as such before the event." For this reason, if the two averages do signal the existance of a bear market, we can only speculate as to the underlying causes. It is possible that a bear market could be brought on by any or all of the following: (1) a long series of disastrous labor-management battles, (2) a full-scale crisis in the money market, (3) a tide of low-priced foreign competition, (4) an impending slow down in business brought on by the fears of consumers, (5) unforeseen political or

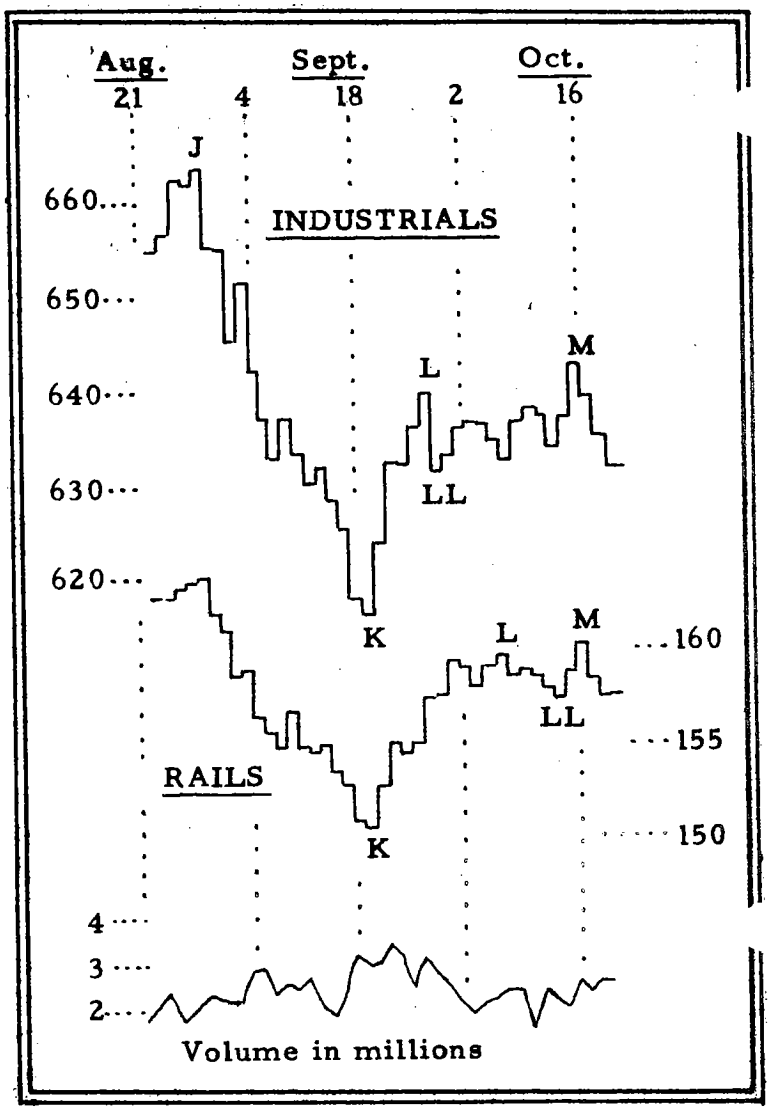
international complications, (6) problems which are not now apparent to this or most other observers.

CURRENT PRICE MOVEMENTS -- A "LINE" The last Letter (81) called attention to a line in the averages. A line is a movement lasting two weeks or longer during which period the price variations in each average fall within a range of approximately 5%. From September 29 to October 15 the industrial average fluctuated within a 9 point range or about 1 1/2% of its price. From September 30 to October 15 the rail average moved within a 2 1/2 point area or about 1 1/2% of its price. The formations lasted for over two weeks and therefore must be considered a definite but rather short line.

The formation of a line implies very evenly matched buying and selling. If the character of the buying proves superior to that of the selling, the floating supply of stock within the line will be absorbed and the formation will be broken upside. Conversely, if the selling is of better quality than the buying, the market will arrive at what Hamilton termed the "saturation point" and the line will be broken downside.

"When a line is in the process of formation it is the hardest thing in the world to tell either the nature of the buying or the selling. Both accumulation and distribution are at work, and no one can say which will ultimately exercise the greatest pressure". (Hamilton)

A line breakout is accomplished when both averages better the upper or violate the lower line limits. A breakout of one average unaccompanied by the other is, more often than not, deceptive. A characteristic of line breakouts is that their forecasting value usually proves superior to that of simple penetrations of both averages through preceding high or low points. Added authority on a line breakout is provided when (1) both averages penetrate on the same day, (2) volume increases importantly on the penetration.



The action of the market last Friday (October 16) was most interesting. To the accompaniment of increased, but not impressive volume , both averages simultaneously bettered the upper line limits -- a move (M on chart) which should have carried a forecast of higher prices. It was generally held, however, that this advance was sparked by the market's anticipating a steel settlement without recourse to Taft-Hartley. Steel negotiations "unexpectedly" broke down over the weekend, and I received many calls from professionals, most of whom predicted that the market would be taken by surprise and that Monday would see panic selling.

My answer was that there have been perhaps a dozen true panics in the last 40 years, and that history shows that the market is seldom taken by surprise.

As it happened, Monday saw no panic selling. Both averages did retreat within

the line area as volume diminished, however, and only time will tell whether Friday's breakout was one of those rare occasions when the market jumps to false conclusions. It can be said that the action of the averages since last Friday has few precedents throughout history; moreover, readers may recall my comment in Letter 81 to the effect that "I would not consider purchases executed on a bettering of L worth the risks involved." That opinion may prove to have been a valid one.

Because of Friday's advance above the line limits, a strict Dow Theory interpretation requires that the secondary trend be considered as up. It will remain up unless one of the following takes place: (1) a series of two or more descending zig-zag structures appear in both averages, (2) both averages violate the lower line limits (LL on chart, industrials 631.68, rails 157.11.)

A violation of the lower line limits would call for extreme caution on the part of investors, and such action would certainly imply that a testing of the all-important K lows is in order. A refusal of one or both averages to violate the lower line limits followed by a series of ascending zig-zags would suggest better things ahead.

BULLISHNESS. The financial world knows that out-and-out bullishness sells; it is good for business. Optimism and hopefulness are held to be constructive while pessimism and caution are considered destructive. For this reason, I am sure that if I affected a consistently bullish tone in all my writing, the circulation of these Letters could be correspondingly increased. Older readers are aware, however, that I attempt to let the averages do the "talking", and any personal opinions and observations which I may have are labeled as such. I also submit that a certain degree of caution during the latter part of a bull market's third phase can be constructive, particularly where the life savings of many readers are involved.

In early August the averages reflected caution, and these Letters accordingly delivered the message. Readers who weighed the evidence and elected to sit tight (barring anything but a bear signal) have watched their assets shrink to some extent, yet they were fully aware of the implications of their decision. Others who took profits near the highs saw their former holdings drop to lower (and in some cases substantially lower) prices. Following an extended primary swing, the trend of the market often becomes obscured, and during these periods many traders and investors prefer to watch from the sidelines. Those who sold out and stayed out have avoided two months of aggravation in a market which was undergoing its first reaction in over two years.

SUNDRY OBSERVATIONS. There are some who say that the big picture is not when the steel strike is settled, but what is behind the steel strike. With the inroads of foreign competition, these analysts believe that the problem is going to be one of decreasing the price of steel in this country. Any wage increase in the face of an eventual decrease in the price of steel could play havoc with steel company profits. This is the big picture, according to these observers, and they feel that this set of circumstances also applies to other industries. It is not a particularly pleasant analysis, and it is one that has mysteriously escaped the newspaper headlines.

Consumer installment credit rose 502 million in August, an amount which surpasses even July's record 500 million increase. The August figure brings the total owed by the U.S. consumer to an all-time high of 37 billion. It can only be hoped that the Russians (who recently inaugurated installment buying) know what they are getting into.

Excellent historical charts of the D-J averages (daily price movements and volume) from 1897 to the present may be obtained from: Traders Research, Inc. Suite 375, Arcade Building, St. Louis 1, Missouri.

(Written: October 21st - morning)